



**COUNCILMEMBER DONNA FRYE**  
City of San Diego  
Sixth District

**MEMORANDUM**

08-08

**DATE:** February 25, 2008  
**TO:** Honorable City Councilmembers  
**FROM:** Councilmember Donna Frye

**SUBJECT:** Protecting Auditor Independence

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My goal to ensure auditor independence is based upon what I believe is in the best interest of the public. Ensuring public confidence in the city's finances begins with the auditor. The auditor is supposed to be an objective third party who performs *independent* examinations that give the city's financial reporting reliability and who is accountable to the independent audit committee, the legislative body and, most importantly, the public. The auditor must be perceived to be independent, both in fact and appearance, from management.

Assessing *independence in fact* is easier than assessing *independence in appearance* so I look to the "*reasonable member of the public standard*" to determine whether a reasonable member of the public would believe that the auditor's relationship with management/mayor might affect the auditor's independence.

In both fact and appearance, allowing the mayor to appoint the city auditor, directly or indirectly, assures a lack of auditor independence, conflicts with common sense ("reasonable member of the public standard") and ignores best practices in Government Auditing Standards (GAS). How can you honestly audit the person who not only appoints you, but also participates in the selection of the majority of the audit committee members who will have the ability to fire you?

In fact, one need only go back to review the experiences of our last city auditor to see how important auditor independence really is and what happens when management has the ability to influence the outcome of the auditor's conclusions. In January, 2007, then

city auditor, John Torell, issued his annual Internal Controls Report. Due to pressure from management, the original Executive Summary had been changed from:

*"... the City's internal controls over financial reporting, as of this report date, are **minimally adequate to assure** timely and accurate preparation of the City's annual financial statements."*

to

*"The City's internal controls over financial reporting, as of this report date, **have improved to permit** timely and accurate preparation of the City's annual financial statements."*

Consider also the mayor's Charter Review Committee and the majority of comments we received from the public who took the time to participate. Most expressed the view that the Committee was *not* impartial and *not* representative of them or the issues they raised. The public perceived that the committee members were not independent from the mayor and did not trust the recommendations. These perceptions were further impacted by the fact that the chair of the Committee was also the co-chair of *San Diegans for City Hall Reform*, a political ballot measure committee established and funded in most part by the mayor's political supporters.

**1. Allowing management/mayor to appoint the city auditor, directly or indirectly, will not ensure that the auditor is independent from management, either in fact or appearance.** In both fact and appearance, this is an organizational impairment because management/mayor already has a direct role in selection of the majority of audit committee members (3 of 5). In appearance, members of the public are less likely to believe that the audit results are reliable because of management's role.

Background:

The Comptroller General of the United States Government Accountability Office (GAO) Generally Accepted Government Auditing Standards (GAGAS) state that: *"The credibility of auditing in the government sector is based on auditors' objectivity in discharging their professional responsibilities. **Objectivity includes being independent in fact and appearance** when providing audit and attestation engagements, maintaining an attitude of impartiality, having intellectual honesty, and being free of conflicts of interest. Avoiding conflicts that may, in fact or appearance, impair auditors' objectivity in performing the audit or attestation engagement is essential to retaining credibility. Maintaining objectivity includes a continuing assessment of relationships with audited entities and other stakeholders in the context of the auditors' responsibility to the public."* (emphasis added)

In addition, it states the following (with emphasis added):

**3.02** *In all matters relating to the audit work, the audit organization and the individual auditor, whether government or public, **must be free from personal, external, and***

***organizational impairments to independence, and must avoid the appearance of such impairments of independence.***

***3.03 Auditors and audit organizations must maintain independence so that their opinions, findings, conclusions, judgments, and recommendations will be impartial and viewed as impartial by objective third parties with knowledge of the relevant information. Auditors should avoid situations that could lead objective third parties with knowledge of the relevant information to conclude that the auditors are not able to maintain independence and thus are not capable of exercising objective and impartial judgment on all issues associated with conducting the audit and reporting on the work.***

***3.04 When evaluating whether independence impairments exist either in fact or appearance with respect to the entities for which audit organizations perform audits or attestation engagements, auditors and audit organizations must take into account the three general classes of impairments to independence--personal, external, and organizational.***

***3.14 Audit organizations in government entities may also be presumed to be free from organizational impairments if the head of the audit organization meets any of the following criteria:***

- a. directly elected by voters of the jurisdiction being audited;***
- b. elected or appointed by a legislative body, subject to removal by a legislative body, and reports the results of audits to and is accountable to a legislative body;***
- c. appointed by someone other than a legislative body, so long as the appointment is confirmed by a legislative body and removal from the position is subject to oversight or approval by a legislative body, and reports the results of audits to and is accountable to a legislative body...***

The Association of Local Government Auditor's (ALGA) states in their 2007 Model Legislation Guidelines that: ***"In order to be independent in fact and appearance, auditors must be free from conflicts of interest and free from how their work is conducted and reported."*** In addition, the Model Guidelines recommend two options for selecting an internal auditor - either one elected by the public or one appointed by the legislative body.

California Government Code Section 1236 (a) states that; "All city, county, and district employees that conduct audits or that conduct audit activities of those respective agencies shall conduct their work under the general and specified standards prescribed by the Institute of Internal Auditors or the Government Auditing Standards issued by the Comptroller General of the United States, as appropriate. The standards generally provide as follows: **That auditors should be independent of the activities they Audit ...**"

2. The only "standard" relied upon by those who support management appointing the city auditor directly or indirectly is the following eight words from the Generally Accepted Government Auditing Standards issued by the United States Government Accountability Office - *appointed by someone other than a legislative body*. However, nowhere in the Government Auditing Standards does it ever state that

management/mayor should be the “*someone other than a legislative body.*” In fact, page after page of the Government Auditing Standards provides standards as to why **auditors must be independent from management**. Neither Mr. Keller, Mr. Goldstone, the Kroll Report, the IBA, nor Council President Peters has been able to provide *any* citation from the Government Auditing Standards that provides for management/mayor appointing the city auditor because such language does not exist.

3. Best Practices regarding who should serve on an Audit Committee are not being followed in the current ballot language. Instead, management/mayor will participate in the selection of three of the five members who shall not be part of the legislative body. In order to ensure auditor independence, both in fact and appearance, we should, at a minimum, follow Best Practices for the city auditor appointment.

Background: The **Government Finance Officers Association (GFOA)** is the professional association of state/provincial and local finance officers in the United States and Canada, with more than 17,300 members and has served the public finance profession since 1906. GFOA members are dedicated to the sound management of government financial resources and provide leadership to the government finance profession through research, education, and recommended practices.

Kroll, and now the City, has chosen not to follow the 2006 recommended practice that, **“All members of the audit committee should be members of the governing body.”**

The **Association of Local Government Auditors (ALGA)** in their *Model Legislation Guidelines for Local Government Auditors*, Third Edition 2007, states, **“To be independent, the audit committee is selected by the legislative body...”**

The **American Institute of Certified Public Accountants (AICPA)** in their Audit Committee Toolkit: Government, states, **“Each member of the audit committee should be appointed by the governing body.”**

4. The GAO is holding a meeting on Monday, February 25, 2008 to discuss independence issues and the conceptual framework for independence standards, which indicates that, notwithstanding the recent revision of GAGAS as of July 2007, further changes are contemplated. There is no indication, based on the 2007 revisions, that the standards for auditor independence will be weakened. The Generally Accepted Government Auditing Standards issued by the United States Government Accountability Office are MINIMUM standards. By their nature, the standards have to be minimum standards to be applicable to many differing governance structures. **The totality of the circumstances needs to be considered. If standards change, we will again to be faced with changing the auditing structure with yet another ballot measure. It makes more sense to do it right the first time.**

5. There needs to be some balance of authority between the branches of government, particularly in financial matters. The legislative branch of government needs to ensure

that the public is being provided with accurate information about the city's financial condition, information upon which they can rely. The executive branch of government has control over the vast majority of financial reporting positions in the city; Treasurer, Comptroller, Chief Financial Officer, and Chief Operating Officer to name a few. In addition, the management members are now the majority of members on the Disclosure Practices Working Group, and the mayor appoints the members of the Public Facilities Financing Authority. Management also has control over all the financial information. We know from experience how difficult it is to obtain information about something as simple as basic service levels in the budget and how long it takes to receive a response from management.

Finally, auditors should be independent from the entity that they are auditing both in fact and appearance. **The goal of independence for a government entity is** to support the public reliance on the financial reporting process. I have identified numerous impairments to auditor independence created by this proposal. If this ballot measure is approved, the auditor's independence will be compromised and the public interest will not be served.

CC: Honorable Mayor Sanders  
Michael Aguirre, City Attorney  
Andrea Tevlin, IBA  
Macias, Gini & O'Connell  
Stanley Keller, Independent Monitor

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